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Executive Secretary

3/14/83

Date

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THE WHITE HOUSE
WASHINGTON

Executive Registry
83-1383

CABINET AFFAIRS STAFFING MEMORANDUM

DDI- 1982/83

DATE: 3-11-83 NUMBER: 118552 CA DUE BY: ______

SUBJECT: Cabinet Council on Economic Affairs - Tuesday, March 15, 8:45 a.m. Roosevelt Room

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☑
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☐	☑
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
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	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Clark	☐	☑
Darman *(For WH Staffing)*	☑	☐
Harper	☑	☐
Jenkins	☐	☑
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CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/Boggs	☐	☐

REMARKS: The Cabinet Council on Economic Affairs will meet Tuesday, March 15, 1983 at 8:45 a.m. in the Roosevelt Room. Agenda and paper is attached.

Agenda:			
	Financial Market Developments and Monetary Policy	CM 111	(paper attached
	National Productivity Advisory Committee	CM 255	(no paper)

RETURN TO:

☐ **Craig L. Fuller**
Assistant to the President for Cabinet Affairs
456-2823

☑ **Becky Norton Dunlop**
Director, Office of Cabinet Affairs
456-2800

DCI EXEC REG

THE WHITE HOUSE

WASHINGTON

March 11, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the March 15 Meeting

The agenda and papers for the March 15 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The first agenda item is a review of Financial Market Developments and Monetary Policy. This item follows up on the Council's consideration of this issue several weeks ago. A paper prepared by Beryl Sprinkel is attached.

The second agenda item is a further report of the National Productivity Advisory Committee recommendations. On February 2 papers on Manufacturing Engineering Education for Higher Productivity and Intellectual Property and Computer Software were circulated. These are also scheduled for discussion.

Attachments

THE WHITE HOUSE

WASHINGTON

THE CABINET COUNCIL ON ECONOMIC AFFAIRS

March 15, 1983

8:45 a.m.

Roosevelt Room

AGENDA

1. Financial Market Developments and Monetary Policy (CM#111)

2. Report of the National Productivity Advisory Committee (CM#255)

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

March 11, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

From: Beryl W. Sprinkel Beryl Sprinkel

Subject: Monetary Policy: The Risks Remain

Recent Monetary Developments

In the Federal Reserve's semi-annual report to Congress on monetary policy, Chairman Volcker stated their commitment to a monetary policy for 1983 which will provide continued progress on inflation, as well as sufficient liquidity to support economic expansion. In general terms, this is the same monetary policy prescription endorsed by the Cabinet Council in early February.

The clarification of Federal Reserve intentions, as well as the disinflationary implications of prospective declines in the price of oil, has aided long-term inflationary expectations and generally improved the tenor of financial markets in recent weeks. Against these favorable financial market developments and reactions are balanced the continuing concern about forthcoming Treasury debt financing and the increasing concern about extremely rapid rates of money growth in recent months.

During the six months ending in January, M1 has grown at an annual compound rate of 12.5%; M1 growth for the month of February is expected to exceed 20% (annual compound rate). It is commonplace to discount recent rapid rates of money growth because of the effects of financial innovation. While it is true that there has been a sizable shifting of funds into the new types of deposit accounts, the bulk of these shifts is occurring <u>within</u> the monetary aggregates and therefore has no net effect on monetary growth rates. The money growth rates are only distorted by financial innovation to the extent that the funds shifted into the new accounts come from instruments not included in the monetary aggregates; in this case, provision of the new accounts induces a shift <u>into</u> the monetary aggregates which distorts money growth upward. When plausible estimates of these shifts are netted out of recent growth rates, money growth remains extremely high. Thus, despite widespread use of financial innovation as an anecdotal justification for excessive money growth, the numbers do not provide supporting evidence for these assertions.

The Future Challenge for Monetary Policy

As a variety of measures of economic activity provide accumulating evidence of an economic recovery, there is considerable basis for optimism about near-term economic performance; continued good news on inflation rates reinforces that optimism, since a low and/or declining inflation rate is a fundamental prerequisite for permanently lower interest rates. The challenge for economic policy now is to assure that the incipient recovery is converted into durable economic growth and lasting price stability.

As we discussed in early February, there are significant risks associated with the conduct of monetary policy in 1983. The danger to the economy, however, is not likely to emerge in 1983. That is, the acceleration of money growth in the last seven months -- unless it is rapidly and abruptly reversed and followed by a prolonged restriction of liquidity as happened in 1982 -- significantly increases the probability that the economy will rebound strongly in 1983. Similarly, the extremely expansionary monetary policy of recent months -- even if it continues -- will not cause an immediate re-emergence of inflation in 1983; the adverse reaction on inflationary expectations and therefore interest rates could, however, come more quickly. The risks associated with monetary policy threaten economic performance in 1984, but economic performance in 1984 will depend importantly on the monetary policy actions taken during 1983.

Whether or not the economic gains made to date evolve into a period of sustained economic growth and price stability depends critically on what happens to interest rates. The behavior of interest rates -- particularly long-term rates -- will be a key factor determining whether or not the capital investment and productivity growth needed for lasting economic growth materializes. While long-term rates have declined substantially from their peaks in 1981, they have not yet fallen to their previous cyclical lows which, by historical standards, were not particularly low. Thus, the trend of secularly rising long-term rates has not yet been broken. If further declines in long rates are not achieved, the implications for long run, real economic growth are not encouraging.

Uncertainty premiums, aggravated by large prospective deficits and the volatility of monetary policy, have been the primary factor maintaining interest rates at high levels, relative to current inflation rates. Both fiscal and monetary policies should focus on reducing the uncertainty about long-run inflation control and the concerns about the Federal Government's absorption of credit in the financial markets, as the economy recovers. Actions to quell these uncertainties and concerns would facilitate the downward adjustment of the risk premiums that continue to be incorporated into the level of interest rates and would greatly enhance the atmosphere and prospects for investment and productivity growth. For monetary policy, that requires stable and predictable money growth that assures investors long-run price stability.

It is an illusion to believe that the problem of inflation has disappeared; interest rates that are high relative to current inflation rates only illustrate this. In the financial markets, the effects of inflation -- that is, the persistent fear that it will reemerge -- linger. Permanent control of inflation and permanently lower interest rates require permanent pursuit of sound, noninflationary monetary policy. Current rates of money growth are not consistent with our desire to contain inflation over the long run. Chairman Volcker has publicly acknowledged this inconsistency on several recent occasions.

There is a frequently-held view that rapid money growth is acceptable -- even desirable -- during a recession to provide economic stimulus. The danger is that highly stimulative, countercylical monetary policy is pursued too far and too long; in so doing, the seeds are sown not only for the next round of inflation, but inevitably for the next recession as well. The stimulative effects of the policy are therefore short-lived and ultimately self-defeating. Reserve and money growth in the present recession already exceeds that of previous postwar recessions; money growth during the last five quarters has proceeded at an annual rate more than three times the average for other recession periods.

There is some tentative evidence that the Federal Reserve has already begun to take the actions needed to slow the rate of money growth. The Federal Reserve Board's measures of reserves and the monetary base have all slowed substantially in the last five or six weeks. There is some ambiguity, however, because this slowdown is not substantiated by the reserve and base data calculated by the Federal Reserve Bank of St. Louis. If the Federal Reserve has moved to slow reserve and money creation, their efforts should be encouraged by the Administration even if those actions cause some temporary upward pressure on short-term interest rates. The monetary data, as well as attitudes and reactions of the financial markets to monetary actions, will be closely monitored in the critical weeks ahead.

A slowdown of money growth is crucial to a sustained, noninflationary expansion. Without it, rising interest rates are the inevitable result, once inflationary expectations are aggravated; the positive gains on inflation will be lost and the price we paid for those gains, by enduring a long and severe recession, will be squandered. How that slowdown is achieved, however, is also critical. As we discussed early in February, there are dangers both in the direction of too much restriction and in the direction of continued excessive money growth. The economic and political implications of either error are sobering.